THE WHITE HOUSE

WASHINGTON

October 14, 1983

MEMORANDUM FOR THE PRESIDENT

FROM: JACK A. SVAHN

SUBJECT: The Economic Women's Equity Act of 1983

Several tax related issues in the Economic Equity Act of 1983 (. 888/H.R. 2090) require resolution. A series of six issue papers, which have been developed by the Department of the Treasury Office of Tax Analysis working with the Office of Policy Development, are attached. They concern:

1. The treatment of alimony as compensation in determining the IRA deduction limit;
2. The treatment of dependent care organization as tax-exempt organizations;
3. Child care information and referral services;
4. Displaced homemakers as a target group for purposes of the Targeted Jobs Tax Credit;
5. The dependent care tax credit; and
6. The tax treatment of unmarried heads of household.

These papers are scheduled for discussion at the Monday, October 17, Cabinet meeting.

Attachments

Issue Paper

S. 888: The Economic Equity Act of 1983

Section 102: Alimony Treated as Compensation in Determining Deduction for Retirement Savings

Current Law

If certain conditions are satisfied, a divorced individual is permitted to deduct IRA contributions up to the lesser of two amounts: (i) $2,000 or (ii) the greater of $1,125 or 100 percent of the sum of such individual's compensation plus taxable alimony received. The applicable conditions are that a spousal IRA have been established for the individual at least five years before the year of divorce and that, for at least three of such five years, deductible contributions have been made to such spousal IRA.

Proposal

Section 102 would repeal the current law. In its place, it would provide that, for purposes of applying the generally applicable deduction limit on IRA contributions, taxable alimony received by a divorced individual may be treated as compensation. Thus, in the case of a divorced individual, the IRA deduction limit would be the lesser of (i) $2,000 or (ii) 100 percent of the sum of the individual's compensation plus taxable alimony received.

Analysis

Compared with current law, section 102 would permit more divorced individuals to treat taxable alimony as compensation for purposes of the IRA deduction limit. Under section 102, however, a divorced individual, including an individual who receives neither compensation nor taxable alimony, would not be assured of being able to make $1,125 in IRA contributions.

Recommendation

Treasury recommends that the Administration support section 102 of S. 888.

Although IRAs originally were intended to enable individuals to save a portion of their compensation for retirement, alimony may be viewed as a shifting of compensation from the payor to the payee and thus, unlike investment income, should be available for IRA contributions. A divorced individual should be permitted to contribute alimony income to an IRA without regard to whether spousal IRA contributions were made for the individual before the divorce.

Approve________ Disapprove________

Issue Paper

S. 888: The Economic Equity Act of 1983

Section 202: Dependent Care Organizations Treated as Tax-Exempt Organizations

Current Law

Organizations that are operated exclusively for religious, charitable, educational, or certain other purposes and which satisfy specified requirements are exempt from Federal income tax. Contributions to such organizations are deductible for Federal income, gift, and estate tax purposes. Other organizations, such as social welfare associations and trade associations, also may qualify for tax-exempt status under one of the specialized exemptions contained in section 501(c). Contributions to such other tax-exempt organizations generally are not eligible for charitable contribution deductions.

The IRS takes the position that an organization that exists to provide care to children in order to allow a parent of a child to be gainfully employed is not an educational organization because its principal activity is not to provide education to children, but instead is to provide day care facilities for the benefit of the parents. The IRS does recognize, however, that an organization that operates primarily to provide dependent care to the children of needy persons may be treated as organized and operated for charitable purposes.

Proposal

Section 202 would provide that an organization will be treated as organized and operated for "educational purposes" if (i) such organization is organized and operated to provide nonresidential dependent care, (ii) substantially all of the dependent care is provided to enable individuals to be gainfully employed, and (iii) the services provided by the organization are available to the general public.

Analysis

Under section 202, a nonresidential dependent care organization that satisfies the proposed requirements would be treated as organized and operated for educational purposes and thus would be exempt from Federal income tax without regard to whether the organization actually is organized and operated primarily for either charitable or educational purposes. In addition, contributions to such an organization would be deductible for Federal tax purposes.

– Recommendation

Treasury recommends that the Administration support section 202 of S. 888 insofar as it would provide organizations that satisfy the proposed requirements with tax-exempt status for Federal income tax purposes. These organizations appear to be just as deserving of tax-exempt status as business leagues, boards of trade, labor unions and similar organizations that have tax-exempt status under current law.

Treasury does not believe, however, that tax deductions should be allowed for contributions to dependent care organizations that are not organized and operated for charitable or educational purposes. Allowing tax deductions for contributions to noncharitable and noneducational dependent care organizations would create significant potential for abuse since these organizations would have strong incentives to characterize a portion of their normal fees as deductible "contributions." Moreover, allowing deductions for contributions to noncharitable and noneducational organizations would reduce the existing tax incentives for dependent care organizations to provide care for needy persons or to conduct educational programs.

Approve______ Disapprove______

Issue Paper

S. 888: The Economic Equity Act of 1983

Section 204: Child-Care Information and Referral Services

Proposal

The Secretary of Health and Human Services would be required to establish a grant program to assist public or private nonprofit organizations in the establishment or operation of community-based child care information and referral centers. A public or private nonprofit organization that desires to receive a grant would be required to submit an application to the Secretary that contains, among other items, a description of the manner in which the center would be established or operated and an estimate of the cost of establishing and operating the center.

Funds would be made available to an applicant only if the applicant provides adequate assurances that the funds would be used solely for the establishment or operation of a child care information and referral center and that any center funded under this provision would provide information to interested persons only with respect to providers of child care services that meet applicable State and local financing and registration requirements. In addition, the applicant would have to assure that, in each year of participation in the grant program, any center receiving funding would obtain the following percentages of its projected budget through non-Federal sources: (i) at least 25 percent in the first and second years, (ii) at least 50 percent in the third year, and (iii) at least 65 percent in the fourth and fifth years. A center would be ineligible for further Federal funding after its fifth year.

The maximum grant to any applicant, for any fiscal year, would be $75,000. The bill would authorize an appropriation of $8,000,000 per fiscal year to carry out this provision.

Each center funded under this provision would be required to submit to the Secretary an annual report concerning its activities.

Recommendation

In its proposed comments on S. 19 and S. 888 to Senator Robert J. Dole, HHS opposed section 204 of S. 888 because the President's 1984 budget does not include funds for the proposed program and because it believed that the proposed program is unnecessary and duplicative of sources already available for funding this service.

Approve______ Disapprove______

Issue Paper

S. 888: The Economic Equity Act of 1983

Section 110: Displaced Homemakers as a Targeted Group for Purposes of the Targeted Jobs Tax Credit

Current Law

The targeted jobs tax credit, which applies to wages paid to eligible individuals who begin work for an employer before January 1, 1985, is available for hiring individuals from one or more of nine targeted groups. Among the targeted groups are economically disadvantaged youths aged 18 through 24, Supplemental Security Income (SSI) recipients, general assistance recipients, and AFDC recipients and WIN registrants. The credit is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of the first $6,000 of qualified second-year wages paid to an individual.

Proposal

Section 110 would add displaced homemakers as a targeted group for purposes of the targeted jobs tax credit. A "displaced homemaker" would be an individual who (i) has not worked in the labor force for a substantial number of years but has, during those years, worked in the home providing unpaid services for family members; (ii) has been dependent on public assistance or on the income of another family member but is no longer supported by that income, or is receiving public assistance on account of dependent children in the home; and (iii) is a member of an economically disadvantaged family and is experiencing difficulty in obtaining or upgrading employment.

Recommendation

Treasury recommends that the Administration oppose section 110 of S. 888. The proposed conditions for "displaced homemaker" status are so vague that the provision is not likely to be administrable. Generally, the conditions associated with the other targeted groups are of a more objective nature. Moreover, this change is not needed to encourage employees to hire economically disadvantaged individuals since existing law already treats recipients of general assistance, certain SSI benefits, or AFDC benefits as members of targeted groups.

Approve______ Disapprove______

Issue Paper

S.888: The Economic Equity Act of 1983

Sections 201, 203: Dependent Care Tax Credit

Background

The Internal Revenue Code provides an individual a credit against income taxes otherwise owed for a percentage of the individual's qualifying dependent care expenses. The credit is not refundable. The creditable percentage (applied to qualifying dependent care expenses) is 30 percent for a taxpayer with adjusted gross income ("AGI") of $10,000 or less, reduced on a sliding scale as AGI increases to 20 percent for taxpayers with AGIs over $28,000.

Qualifying dependent care expenses per year are limited to $2,400 for one qualifying dependent and $4,800 for two or more qualifying dependents. Consequently, for taxpayers with AGIs of $10,000 or less (30 percent credit), the maximum credit is $720 for one qualifying dependent and $1,440 for two or more qualifying dependents. Similarly, for taxpayers with AGIs over $28,000 (20 percent credit) the maximum credit is $480 for one qualifying dependent and $960 for two or more qualifying dependents.

The Economic Recovery Tax Act of 1981 ("ERTA") increased the credit, with the greatest increase going to low-income taxpayers. Prior to ERTA, the credit was 20 percent for all taxpayers, not just for those with incomes above $28,000 as under current law. ERTA also increased the maximum amount of creditable expenses from $2,000 for one qualifying dependent and $4,000 for two or more qualifying dependents. Consequently, ERTA raised the maximum credit for low-income taxpayers ($10,000 or less AGIs) from $400 for one qualifying dependent and $800 for two or more dependents to $720 and $1,440, respectively.

The Conable Proposal

The Conable Proposal would raise the credit still further for those with AGIs below $40,000. The creditable percentage (applied to qualifying dependent care expenses) would be 50 percent for taxpayers with AGIs under $11,000, reduced by a sliding scale to 20 percent for taxpayers with AGIs of $40,000 or more. Consequently, those with AGIs below $11,000 would have their maximum credit raised to $1,200 for one qualifying dependent and $2,400 for two or more qualifying dependents. All taxpayers with AGIs under $40,000 also would receive an increase. Because many low-income taxpayers do not owe sufficient tax to make full use of the increased credit, the proposal also would make the credit refundable. If the credit exceeds taxes owed, the excess would be paid in cash to the taxpayer. The Conable Proposal would cost approximately $1 billion a year as follows:

Fiscal Years ($ billions)

	1984	1985	1986	1987	1988
Credit Change	*	0.6	0.8	0.8	0.8
Refund-ability	*	0.3	0.3	0.3	0.4
	*	0.9	1.1	1.2	1.2

(Totals may not add due to rounding.)

Alternative Proposal

An Alternative Proposal would restructure the credit so that more benefits would be available for those with low incomes and less benefits would be available for those with higher incomes. By reallocating benefits, the Alternative Proposal would benefit low-income taxpayers without a reduction in Federal revenues. It would change the creditable percentage to 50 percent for those with incomes under $11,000, phasing out as AGI increases, until the credit is zero for those with incomes of $50,000 or more. The Alternative Proposal would not make the credit refundable.

Options

Option 1: Support the Conable Proposal (S.888) to increase the dependent care credit for taxpayers with adjusted gross incomes below $40,000.

Advantages:

- The Conable proposal provides increased credits for those with AGIs under $40,000 without reducing the credits for any current recipients.

Disadvantages:

- The proposal entails a substantial revenue cost.
- It would establish the precedent of using refundable tax credits to help low-income persons instead of using direct expenditures, a precedent we have consistently and successfully avoided in the past.

Option 2: Support an Alternative Proposal to provide a revenue neutral modification to increase the dependent care credit for those taxpayers with adjusted gross incomes below $35,000 and to reduce the credit for those with incomes above this amount.

Advantages:

- The Alternative Proposal increases credit benefits for low-income taxpayers with no revenue loss and without making the credit refundable.
- Compared to present law, the proposal increases benefits for those with AGIs below $35,000.
- Compared to the Conable Proposal, the Alternative Proposal provides the same benefits for those with AGIs under $21,000 and only slightly reduced benefits for those with AGIs under $40,000.

Disadvantages:

- Compared to present law, the Alternative Proposal reduces benefits for those with AGIs over $35,000.
- Compared to the Conable Proposal, the Alternative Proposal reduces benefits for those with AGIs of $21,000 or more.
- The Alternative proposal eliminates all credit benefits for those with AGIs of $50,000 or more.

Option 3: Support Present Law.

Advantages:

- Current law does not have the revenue cost of the Conable Proposal.

- Current law treats those with AGIs over $35,000 more favorably than the Alternative Proposal.

Disadvantages:

- Doing nothing gives the appearance of insensitivity to women's concerns for greater assistance for single heads of household and low and middle income two-worker married couples with children.

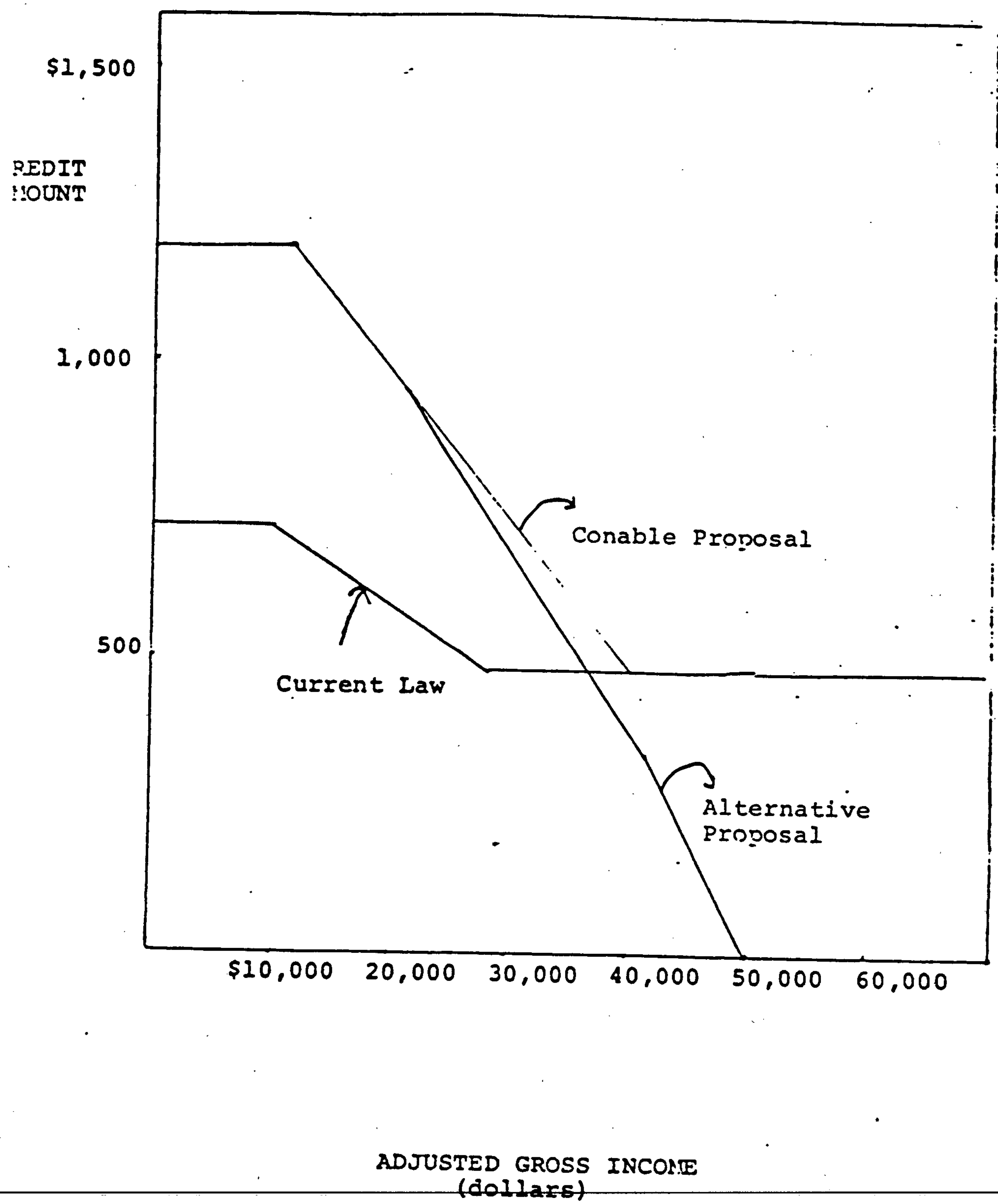
Decision

Option 1 _____ Support the Conable Proposal (S.888) to increase the dependent care credit for taxpayers with adjusted gross incomes below $40,000.

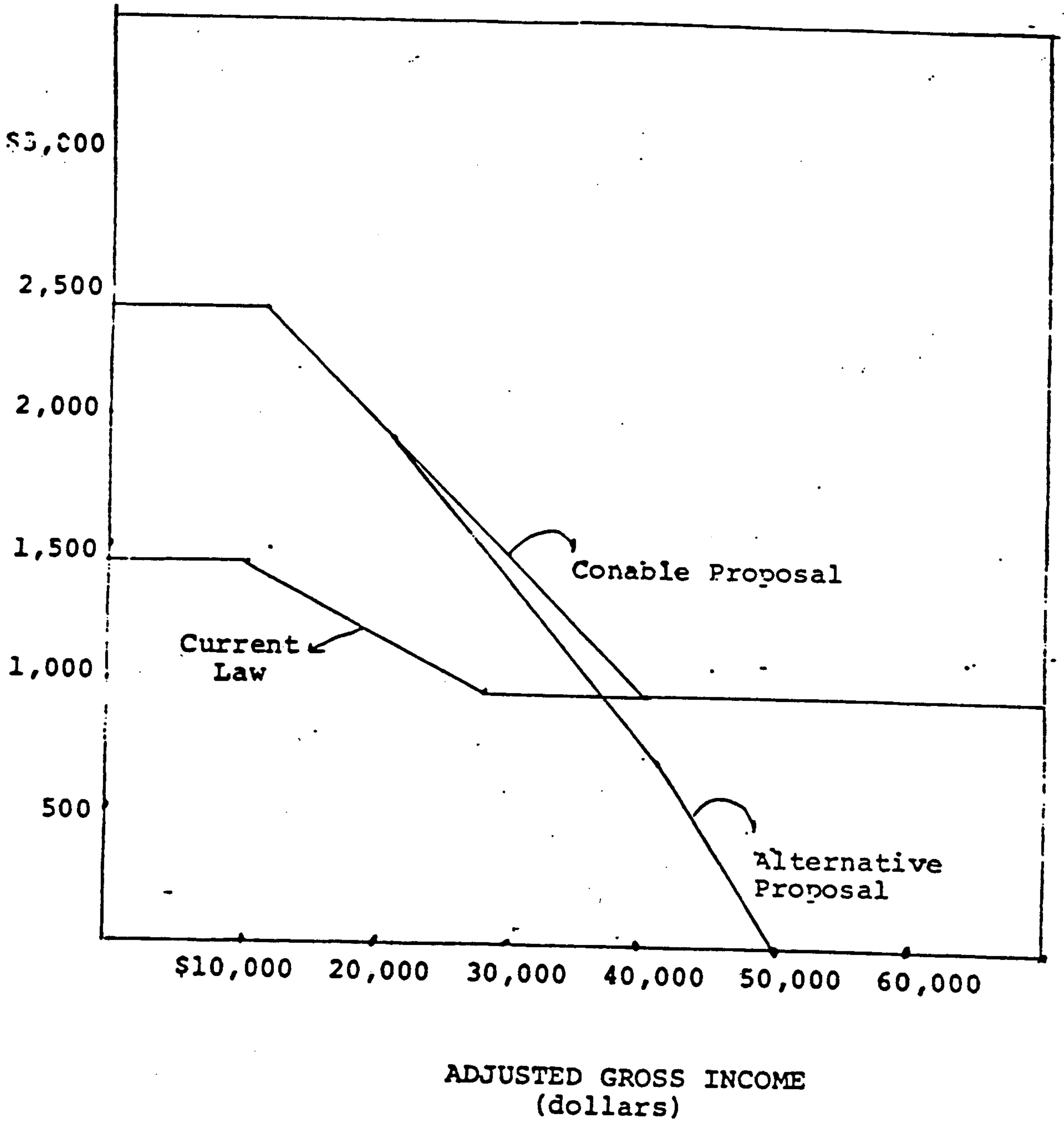
Option 2 _____ Support a revenue neutral modification to the dependent care credit to increase the credit for those taxpayers with adjusted gross incomes below $35,000 and to reduce the credit for those with incomes above this amount.

Option 3 _____ Support present law.

MAXIMUM DEPENDENT CARE CREDIT FOR ONE DEPENDENT



MAXIMUM DEPENDENT CARE CREDIT FOR TWO DEPENDENTS



Effect on Receipts of Proposed Change in Child Care Credit

Effective January 1, 1984

($ millions)

	1984	1985	1986	1987	1988
Fiscal year effect	-25	-234	-145	16	197

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Note: Proposed schedule was chosen so as to make the change in liability over the calendar year period, 1984-1988, approximately neutral. This would have the effect of making the change approximately neutral over the budget fiscal year period, 1984-1989.

Child Care Credit under Current Law and Proposed Credit
Distributed by Adjusted Gross Income Class

Adjusted gross income class	Present law credit		Proposed law credit 1/	
	Amount	Percentage distribution	Amount	Percentage distribution
($000)	($ millions)	(.. percent ..)	($ millions)	(.. percent ..)
Less than 10	$ 90	3.6%	$ 106	4.2%
10 - 20	518	20.7	806	32.2
20 - 30	563	22.5	857	34.2
30 - 40	544	21.7	558	22.3
40 - 50	334	13.3	175	7.0
50 and over	452	18.0	--	--
Total	$2,501	100.0%	$2,502	100.0%

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1/

Adjusted gross income class ($000)	Credit rate as a percent of eligible expenditures
0 - 10	50%
10 - 20	50% less 1% per $1,000 in excess of $10,000
20 - 30	40% less 1.3% per $1,000 in excess of $20,000
30 - 40	27% less 1.3% per $1,000 in excess of $30,000
40 - 50	14% less 1.4% per $1,000 in excess of $40,000
50 and over	0

Note: Details may not add to totals due to rounding.
Amounts shown are at 1986 levels.

Returns with Change in Tax under Proposed Change in Child-Care Credit by Adjusted Gross Income Class

(Number of returns in thousands)

Adjusted gross income class ($000)	Returns with reduced tax	Returns with increased tax	Returns with no change
Less than 10	209	--	141
10 - 20	1,351	--	170
20 - 30	1,871	--	29
30 - 40	930	931	--
40 - 50	--	1,201	--
50 and over	--	941	--
Total	4,361	3,073	340

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Note: Numbers of returns at 1986 level.

Issue Paper

S. 888: The Economic Equity Act of 1983

Section 111: Tax Treatment of Unmarried Heads of Household

Background

Joint Return Tax Rates. In 1948, spousal "income-splitting" for income tax purposes was introduced in the form of joint return tax rates. Although introduced to eliminate the difference in taxation between married couples residing in community property and non-community property states, income-splitting also eliminated income tax differentials among married couples with equal combined taxable incomes but unequal divisions of income between spouses. The principal result of spousal income splitting was that it reduced the income taxes of a couple as compared with an unmarried person with the same amount of income.

Income-splitting was accomplished by introducing a new tax rate schedule for joint income tax returns under which the combined income of both spouses was taxed. The new tax rate schedule for joint returns resulted in exactly the same tax for the married couple as if one-half of the couple's combined income had been taxed to each spouse and the tax computed under the prior law tax rate schedule.

Head of Household Treatment. The availability of the benefits of spousal income-splitting provoked complaints of inequity from other taxpayers who were in family-like situations but who were not married. In response, in 1951 Congress introduced a new tax rate schedule for so-called "heads of households" who are unmarried taxpayers supporting and maintaining a household for at least one dependent, typically a parent or a child. For any given amount of taxable income, the head of household tax rate schedule generated an income tax approximately halfway between the unmarried and joint rate schedules. Thus, it is often said that heads of households get half the benefits of income-splitting. They get this benefit because of their family situation, and not because a second income is being taxed on the same tax return. Since the standard deduction was the same on a joint return as on a single return, the standard deduction on a head of household return was also the same.

In 1969, as the result of increasing complaints from single taxpayers about the benefits of spousal income-splitting for one-earner married couples, Congress introduced a tax rate schedule for single taxpayers under which the tax at a given level of taxable income never exceeded 120 percent of that on a joint return. At the same time, head of household tax rates were reduced so that the tax fell approximately halfway between the taxes produced by the single and the joint tax rate schedules. Thus, the percentage of tax relief for heads of households, as compared with married couples filing jointly, decreased.

Zero Bracket Amount. Since 1964, the standard deduction has undergone frequent and significant changes until it has been transformed into the zero bracket amount (ZBA) currently in effect. The ZBA is a flat amount for each taxpayer, is unrelated to the taxpayer's income, depends on the taxpayer's filing status, and is folded into the tax rate schedules themselves. The current ZBA is $3,400 on a joint return, $1,700 for a married taxpayer filing a separate tax return, and $2,300 for single taxpayers and heads of households. A zero rate of tax applies to these first taxable income brackets of each rate schedule.

Originally, the standard deduction was merely a means of simplifying tax-filing and recordkeeping; it served as a proxy for an average taxpayer's itemized deductions. Since the mid-1960's, the standard deduction has had a second purpose. Together with the personal exemption, it has been used to establish the floor on taxable income below which there would be no tax. Usually, some attempt has been made to assure that the lowest level of income subject to tax is at or above the officially defined "poverty line."

Proposal

S. 888 includes a provision that would increase the zero bracket amount (ZBA) for heads of households from $2,300 (the amount now allowed for single persons) to $3,400 (the amount now allowed on joint tax returns). The logic of this proposal is that heads of households have family responsibilities similar to those of married couples; hence, they should be allowed the same ZBA as married couples.

An alternative proposal would raise the ZBA for heads of households to $2,850, halfway between the amounts allowed on single returns and joint returns. The logic is that since heads of households receive half the benefits of income splitting in their tax rate schedule, they should also receive half the benefits of income splitting in the ZBA.

Analysis

Taxpayers with lower incomes generally have fewer itemized deductions and, therefore, tend to use the ZBA more than do higher income taxpayers. On the average, heads of households have lower incomes than do taxpayers in general. Consequently, heads of households use the ZBA more than other taxpayers.

However, in lower income classes, heads of households tend to use the ZBA less than taxpayers in general at the same income levels. Within the $15,000 to $30,000 income class, a $3,100 ZBA for heads of households would result in such taxpayers using the ZBA approximately as frequently as married couples filing jointly currently do in that income class:

Use of the Zero Bracket Amount by Taxpayers with AGI's from $15,000 to $30,000

Current Law ZBA	Percent Using ZBA	Proposed Head of Household ZBA	Percent Using ZBA
Single return....	63%	$2,850.....	55%
Joint, married filing separately, and surviving spouse return....	57%	$3,100.....	57%
$2,300 head of household........	46%	$3,400......	60%
All filing types............	58%		

The percentages shown above for current law usage of the ZBA suggest that heads of households have more itemized deductions in excess of the ZBA than other taxpayers with similar incomes.

Two additional tables are attached. Table 1 shows the revenue estimates for both proposals, annually for 1984 through 1988. Table 2 shows the distribution of the benefits and the numbers of beneficiaries by adjusted gross income class, under both proposals.

Options

Option 1: Support an increase in the ZBA to $3,400 for Heads of Households.

Advantages:

- The proposal would benefit heads of households by an average amount of about $180 per return using the ZBA (at 1988 income levels).
- It would give the same benefit to heads of household as is given to married couples because heads of

households are very similar to married couples in their dependent support responsibilities.

- The benefits of the tax reduction would be concentrated on lower income people, presumably those most in need of tax relief. (See table 2.)

Disadvantages:

- The proposal costs about $1 billion a year in lost tax revenue.

- Traditionally, heads of household have received the same standard deduction or ZBA as single persons. Even with preferred tax rate schedules, the most benefit that heads of household have ever received is one-half of the benefits of spousal income splitting. This proposal would grant the full benefits of income-splitting at certain income levels.

- This proposal would shift the relative tax burden to other, non-head of household taxpayers.

- The principal justification for spousal income splitting is the existence of two incomes. On head of household returns, only one income is included. Thus, special benefits are not warranted, especially extra benefits on top of the tax rate benefits already provided.

- If it is considered desirable to provide benefits to lower income people, it should be accomplished directly on the basis of income and not on the basis of filing status.

- The proposed tax reduction would go only to non-itemizers, and at similar income levels a disproportionately low level of heads of household use the ZBA.

Option 2: Oppose a Change in the ZBA for Heads of Households.

Advantages and Disadvantages: (See Disadvantages and Advantages for Option 1.)

Option 3: Support an increase in the ZBA for Heads of Households to $2,850, half way between the single and joint returns.

Advantages:

- Heads of households now get half the benefits of income splitting in their tax rates. They should get the same benefits in other parameters of the tax system.

- This halfway compromise may satisfy proponents of an increase in the ZBA for single heads of household.

Disadvantages:

- This increase in the ZBA would cost about $500 million a year in lost tax revenue.
- Traditionally, heads of household have received the same standard deduction or ZBA as single persons. Per capita personal exemptions adequately adjust for family size differences.

Decision

Option 1 ________ Support an increase in the ZBA to $3,400 for heads of households.

Option 2 ________ Oppose a change in the ZBA for heads of households.

Option 3 ________ Support an increase in the ZBA for heads of households to $2,850.

Attachments

Table 1

Effect of Proposed Increases in the
Zero Bracket Amount for Heads-of-Households 1/
Effective January 1, 1984
($ millions)

	Fiscal Years				
	1984	1985	1986	1987	1988
Increase Head of Household zero bracket amount to:					
$2,850	-264	-444	-462	-480	-500
3,400	-541	-905	-941	-979	-1018

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1/ Amounts are the net increase in the deficit resulting from reductions in tax revenues and increases in earned income credit outlays resulting from each proposal.

Table 2

Effects of Proposed Increases in the Zero Bracket Amount for Heads-of-Households Distributed by Adjusted Gross Income Class

(1984 law, 1982 levels of Income)

Adjusted gross income	Number of heads-of-household returns	1984 law tax liability for heads-of-households	Change in tax liability due to increasing the zero bracket amount to: $2,850	$3,400	Number of returns with a tax reduction due to increasing the zero bracket amount to: $2,850	$3,400
	(Thous.)	(. . . . . . . $ Millions.	. . . .	. . . . .)	(. . . Thousands	. . .)
Less than 5 1/	1,300	$-318	$ -11	$ -13	237	237
5-10 1/	2,420	-47	-122	-242	2,036	2,092
10-15	1,741	1,473	-120	-248	1,495	1,540
15-20	1,180	1,832	-69	-145	725	782
20-30	957	2,641	-52	-112	444	491
30-50	334	1,690	-9	-21	61	74
50-100	56	713	*	*	1	1
100-200	10	386	*	*	*	*
200 or more	3	531	*	*	*	*
Total	8,000	$8,901	$-383	$-781	4,999	5,216

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note: Details may not add to totals due to rounding.

* Less than $500,000 or 500 returns.

1/ Tax amounts shown include earned income credit outlays.